University of Richmond Law Review

Volume 31 | Issue 5 Article 9

1997

ESOP's Fables: Leveraged ESOPs and Their Effect on Managerial Slack, Employer Risk and Motivation in the Public Corporation

Hunter C. Blum
University of Richmond

ESOP'S FABLES: LEVERAGED ESOPS AND THEIR EFFECT ON MANAGERIAL SLACK, EMPLOYEE RISK AND MOTIVATION IN THE PUBLIC CORPORATION

> [J]ust as quality was the watchword of the 80's in American business, . . . ownership . . . will be the most significant issue of the 90's. As pressure for improved performance and increased shareholder value mounts, the question of who is going to participate in making the really important decisions in corporate America will move to the front burner. In a climate of perceived corporate inefficiency and wastefulness . . . and of increased demand from employees wanting a stronger voice in determining how their present and future security is going to be handled, the answer to the question of who is going to participate has the potential for dramatically reshaping the landscape of the American corporate enterprise . . . .[1]

Shareholder rights and their influence on corporate governance have become an increasingly important topic in corporate law. The recent wave of corporate downsizing in the early 1990's has disturbed our collective equilibrium. Many now challenge the basic corporate law tenet that the directors hold a fiduciary duty to the shareholders only and the traditional idea that the proper corporate goal is shareholder wealth maximization.

The concept of the corporation is being challenged because employees, suppliers, creditors and society as a whole have a limited role in corporate governance. In relation to employees, the current corporate governance structure in the U.S. creates intangible costs to society which the corporation manages to evade. Laid-off employees suffer both financially and from self-esteem and morale problems; creditors can be left vulnerable; consumers lose access to products and services; and the commu-

1. JOSEPH R. BLASI & DOUGLAS L. KRUSE, THE NEW OWNERS 194 (1991) (quoting I. M. Booth, President and Chief Executive Officer, Polaroid Corp.).

nity can lose tax revenue and charitable contributions as well as tax concessions already paid.[2]

Disparities in bargaining power create inadequate contractual employee self protection.[3] Obligations exist independent of employee consent, and disparities in bargaining power should not allow unjust outcomes.[4] There is a preoccupation with a perceived trend toward short-term corporate profit maximization at the expense of the employee and other non-shareholder stakeholders.[5]

The dilemma poses many questions: Is short-term profit maximization a legitimate corporate goal? In the alternative, could it be viewed as a breach of a director's fiduciary duty to the shareholders? Are the default corporate governance rules, which permit inadequate bargaining power in at-will employment, shareholder monopoly over control, limited liability, and fiduciary duty to shareholders only, biased in favor of the corporation? Are they in need of modification so that the corporation internalizes the societal costs which result because of corporate decision-making?[6] Is job security really an implied contractual obligation? Is employee participation in corporate decision-making practical or feasible? Are the voluntary Japanese and mandatory German participatory models feasible in our U.S. culture?[7] What would be the market reactions to any proposed changes in corporate governance and would they cause such volatility as to reduce both shareholder wealth and employee job security? Is the underlying reasoning supporting our economy and corporate governance flawed?[8]

---

2. *See* David Millon, *Communitarianism in Corporate Law: Foundations and Law Reform Strategies*, *in* PROGRESSIVE CORPORATE LAW 1 (Lawrence E. Mitchell ed., 1995).

3. *See id.* at 5; *see also* Marleen A. O'Connor, *Promoting Economic Justice in Plant Closings: Exploring the Fiduciary/Contract Law Distinction to Enforce Implicit Employment Agreements*, *in* PROGRESSIVE CORPORATE LAW, *supra* note 2, at 219; Marleen A. O'Connor, *Global Capitalism and the Evolution of Corporate Governance Institutions*, *in* PERSPECTIVES ON COMPANY LAW 1, 1-33 (1996).

4. *See* Millon, *supra* note 2, at 5-7.

5. *See id.* at 2.

6. *See id.* at 24.

7. *See* Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327, 328-29 (1996).

8. *See* Lynn L. Dallas, *Working Towards a New Paradigm*, *in* PROGRESSIVE CORPORATE LAW, *supra* note 2, at 35.

These are all difficult questions. For others, the United States has no problems, only differences.[9] Our people are heterogeneous, and our culture highly individualistic. These qualities make for an entrepreneurial environment particularly conducive to capitalism. Relative to the world economy, the United States is enjoying a time of steady economic growth and low unemployment. In contrast, the participatory models of Japan and Germany are struggling with low to negative growth and high unemployment.[10]

These responses notwithstanding, it is easy to sympathize with a downsized employee and to seek alternative forms of employee self-protection. However, the question remains: are radical reforms and unconventional legal theories necessary or do alternatives already exist within the current statutory framework? The topic of employee owned companies goes a long way towards reconciling the conflicting interests between shareholders and employees. If they are one in the same, a fiduciary duty to the shareholder would also represent a fiduciary duty to the shareholder-employee. The conflicts between the shareholder and employee would thus be seemingly removed or reduced. The National Center for Employee Ownership reports that over 9,500 U.S. companies have employee stock ownership plans, covering over ten million employees and $150 billion in corporate stock; and thirty percent of the Fortune 100 companies have employee stock ownership plans (ESOPs).[11] These type of numbers suggest that workers have enough alternatives to choose among companies which permit greater employee participation through ownership. With real choices, the inadequacy of worker self-protection in bargaining for employment is, on the surface, at least somewhat ameliorated. The subsequent issues become, do ESOPs really work in affording employees greater

9. *See generally* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 644 (1996); Mark J. Roe, *The Political Roots of American Corporate Finance*, BANK OF AM. J. APPLIED CORP. FIN., Winter 1997, at 8.

10. *But cf.* RAY MARSHALL, UNHEARD VOICES: LABOR AND ECONOMIC POLICY IN A COMPETITIVE WORLD 4 (1987) (stating that the lack of industrial or economic democracy has hurt the U.S. competitive position). Would he make the same statement today?

11. *See* Edward J. Giblin & Jack L. Murphy, *When Employees Own the Company*, ACROSS THE BOARD, Oct. 1995, at 42.

protection resulting in happier and more productive employees; and what are the trade-offs?

Employee ownership may take many different forms.[12] This paper will address the topic of partial employee-owned companies, and more specifically, leveraged ESOPs in publicly traded corporations and their implications for corporate governance, employee risk-taking and corporate productivity. Part I discusses the basic background and operation of ESOPs and how they are encouraged from a policy making perspective. Part II addresses the effects of leveraged ESOPs on reducing managerial slack. Part III examines the implications of leveraged ESOPs on employee risk-taking. Finally, part IV studies the proclivity of employee ownership to motivate workers toward increased productivity.

I. A BRIEF ESOP STATUTORY BACKGROUND

The Internal Revenue Service first published a ruling allowing corporations to use stock bonus or profit-sharing plans to borrow money for investment in company stock in 1953, and "[t]hus appeared the distinctive feature of the Employee Stock Ownership Plan: the use of financial leverage to allow employees to buy stock in their own companies without putting up any of their own money."[13] Subsequently, Louis Kelso created the first ESOP at Peninsula Newspapers, Inc.[14] From 1973 to 1991 Congress enacted more than fifteen separate laws regarding ESOPs.[15] According to the conceptual model behind the legislation, "employee ownership should and would broaden and expand ownership; encourage capital formation and innovative corporate finance; improve labor-management relations, productivity, and profitability in firms; help the economy accommodate developments in technology, the spread of transfer payments, and inflation; and create an economic democracy."[16]

12. *See* BLASI & KRUSE, *supra* note 1, at 21.
13. JOSEPH R. BLASI, EMPLOYEE OWNERSHIP: REVOLUTION OR RIPOFF? 18 (1988).
14. *See id.*
15. *See id.*
16. *Id.*

An ESOP is a tax-qualified, defined contribution plan of deferred compensation under § 401(a) of the Internal Revenue Code of 1986 (I.R.C.), with its primary objective to provide stock ownership interests to its employees.[17] Under I.R.C. § 401(a), ESOPs must exist for the exclusive benefit of the employees. The Employee Retirement Income Security Act of 1974 (ERISA)[18] governs ESOPs, granting many exceptions which defy ERISA's purpose of protecting retirement income. An important ESOP exception to ERISA is the lack of diversification rules, defining an ESOP as a stock bonus plan designed to invest primarily in employer stock.[19] Use of an ESOP as a technique of corporate financing is recognized under both I.R.C. and ERISA.[20]

As a matter of public policy, the U.S. government has created significant tax incentives to encourage companies to move toward employee ownership. However, the question remains: who do these policies really benefit?

Usually with an ESOP, a trust is established to purchase shares of the corporation's stock from either the corporation itself or its existing stockholders.[21] In the case of a leveraged ESOP, the ESOP (or the corporation in setting up the ESOP) borrows the money to purchase the corporation's stock, and then uses the dividends to pay back the loan.

Contributions to the ESOP as well as dividends paid to the participants (or to the ESOP used to pay ESOP debt on the acquired shares) are tax deductible to the corporation.[22] In contrast, dividends paid to non-corporate entities are normally paid from the corporation's after-tax dollars. Additionally, for a leveraged ESOP, the dividends used to pay off the loan are also untaxed. Furthermore, if the ESOP acquires more than fifty percent of the corporation's stock, the lender may be able to

17. *See* Rev. Rul. 69-65, 1969-1 C.B. 114.

18. 29 U.S.C. § 1001 (1994).

19. *See* I.R.C. § 4975(e)(7) (1997).

20. *See* Ronald L. Ludwig, *Design and Purpose of an ESOP: Techniques Special Features and Incentives in Utilizing ESOPs*, 375 P.L.I. TAX L. & PRAC. 83, 89 (1995) (referring to Rev. Rule 79-122).

21. *See* James J. Hanks, Jr., *ESOPs after NCR: A Blurred Image of Polaroid*, INSIGHTS, July 1991, at 3.

22. *See* I.R.C. § 404(k) (1997).

exclude fifty percent of the interest income from taxation,[23] which often results in the lender charging a lower rate of interest. Finally, a stockholder of a closely held corporation selling thirty percent or more of its shares to an ESOP can defer federal income taxes on the sale by reinvesting the proceeds in stocks or bonds of a U.S. company.[24]

Many potential uses of an ESOP exist. For employees, ESOPs can serve as a benefit or retirement program and as an employee incentive program. As a financing mechanism, the corporation can obtain debt financing for corporate acquisitions or expansion using pre-tax corporate dollars for repayment, finance corporate buyouts, and use ESOPs as a takeover defense strategy.[25] Can these many uses mesh to promote increased economic democracy? Or is the ESOP a corporate welfare farce used to further entrench an already slack management?[26]

II. ESOP AS CORPORATE WELFARE AND ITS EFFECT UPON MANAGERIAL SLACK

A fundamental ESOP issue is the conflicting interests between corporate financing objectives and economic democracy. The laws as they exist can be used to further entrench an already well-bunkered management. Management accomplishes many objectives in designing an ESOP. Primarily, management can reduce its cost of capital, avoid the balancing effects of debt, and accomplish even greater shareholder dilution. All of these factors lead to a further entrenchment of management.

The costs of raising capital are many and a rational company seeks to reduce these costs as much as possible. For the public corporation, raising capital forces one primary decision: the

23. *See* I.R.C. § 133 (repealed 1997).
24. *See* I.R.C. § 1042 (1997).
25. *See* Ludwig, *supra* note 20, at 91-92.
26. An additional use of an ESOP in a closed corporation includes the creation of a market for the stock and for estate planning purposes, which this paper does not seek to address. According to an article in the Wall Street Journal, approximately 85% of the estimated 10,000 to 11,000 ESOPs in the United States have been established by privately-held businesses, and roughly 500 new ESOPs are formed each year by family concerns. *See* John R. Emshwiller, *Taking Strategy: The Pros and Cons of Employee Stock Ownership Plans*, WALL ST. J., Mar. 22, 1991, at B14.

choice between debt or equity. Raising equity funds is costly, requiring underwriters, attorneys and accountants. Potential shareholders seek higher returns from equity than debt because their risk levels are higher and their returns variable. Thus, equity holders are motivated by their full participation in the upside of a highly profitable business. Finally, equity usually requires the payment of some type of regular dividends, which come from a firm's after-tax profit. Thus, these dividend returns are, in effect, subject to double taxation.[27] Equity also results in the addition of more owners who may attempt to meddle in corporate management.

Conversely, debt is generally cheaper to issue than equity, as there are less agency costs involved, especially when dealing directly with a bank. Unlike dividends, debt payments are tax deductible, providing a significant tax shield, reducing their overall costs. Finally, debt, because of its fixed quasi-guaranteed return, will not realize greater returns during prosperous times. Debt risks only default during less prosperous times. As a result, it appears that debt is far cheaper than equity in many ways.

Michael Jensen suggests that debt is an effective form of capitalization or financing because it helps reduce managerial slack.[28] First, a greater debt to equity ratio gives shareholders more leverage to control managerial slack. A smaller equity pool allows an investor to control more of a company with a smaller investment. Thus, debt concentrates dispersed equity ownership. And with greater ownership concentration, investors are more capable of actually behaving as owners. Second, debt reduces managerial slack because creditors monitor the compa-

---

27. This assumes the dividend recipient is not a corporation. Corporations, depending on their status, receive a tax exclusion on at least a portion of their dividend returns, allowing at least a deferral on the second level of federal taxation until those same dividends are distributed to their own shareholders. *See* I.R.C. § 243 (1997).

28. *See* Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61, 67-68 [hereinafter Jensen, *Eclipse*]. *See generally*, Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831 (1993); Sangsoo Park & Moon H. Song, *Employee Stock Ownership Plans, Firm Performance, and Monitoring by Outside Shareholders*, FIN. MGMT., Winter 1995, at 52; Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

ny closely with informational trip wires in the form of covenants. This reduces managerial slack as the creditor can actually exercise some contractual control. With less leeway, management must stay on its toes. Finally, in addition to their increased proportional ownership share, investors are motivated to monitor the company more closely as the increased debt-equity ratio places a company closer to insolvency. As a result, Jensen suggests that management has less flexibility when there is less equity capital and is, therefore, more motivated to do a better job.[29] It follows that debt can beneficially influence management behavior.[30]

Underlying the comparison of debt and equity is the idea that debt is cheaper than equity. If debt is cheaper than equity (and even has beneficial effects upon management), is there anything cheaper than debt? Yes, the combination of debt and equity in the form of leveraged ESOPs is the cheapest form of raising capital. Even more disturbing is that this form of capital formation may in many ways deter the beneficial effects of reducing managerial slack inherent in increased debt.

An ESOP can be the cheapest method of capital formation. A bank lends money directly to an ESOP (or to a company who then lends to the ESOP) to purchase shares of the company. The company issues new shares without having to go through the expense of a public offering or fulfilling disclosure requirements.

The economic reality is that the corporation is borrowing money from the lender and securing the loan with newly issued equity shares (in the name of the ESOP). Instead of having to pay both dividends from after-tax dollars on the new equity and debt payments on the loan, the corporation simply uses the dividends to help pay off the loan. These dividends, as well as the loan payments, are tax deductible. Since the loan is secured, the interest rate is relatively low. Because the creditor is actually allowed to deduct a percentage of the income earned from the ESOP loan, it can offer an even lower interest rate.

---

29. *See* Jensen, *Eclipse*, *supra* note 28, at 68-71.
30. *See* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073 (1995).

Management accomplishes many self serving objectives in forming a leveraged ESOP. First, management raises capital at the lowest interest rate possible. The lower the interest rate, the lesser the effect of debt on moderating management. Second, in taking out debt while issuing equity, management alters the debt-equity ratio only slightly. Shareholder value and power is actually diluted by issuing more shares. Subsequently, the debt issuance does not have the same effect of concentrating ownership in a smaller equity pool; nor is the corporation closer to insolvency. Thus, investors have little more incentive to behave as managers and lenders have less reason to monitor management more closely. Third, this type of leveraged ESOP lending tends to have less managerial trip wires, diminishing the information and power of creditors to reduce managerial slack. As a result, management has circumvented the beneficial effects of debt financing. Far from reducing managerial slack, with a leveraged ESOP, management is further entrenched with a lower cost of capital that simultaneously diminishes the beneficial effects of debt on managerial slack. Shareholders have less incentive to behave as managers because their piece of ownership pie has actually been reduced and the corporation is no less closer to insolvency.

Leveraged ESOPs can also be used strategically to help prevent a hostile takeover.[31] Specifically for large companies in low growth industries, the increased use of debt in the public corporation actually serves to reduce managerial slack. Similarly, leveraged buyouts (LBOs) accomplish the same purpose.[32] By taking over a company through an LBO, the new management drastically alters the debt-equity ratio of the company. By distributing equity and using debt instead, the corporate raiders execute an economically rational objective for its shareholders: free the cash so that the shareholders can invest it in more profitable projects since the company has none. Leveraged buyouts free cash used unproductively, in turn reducing man-

31. *See* Mario L. Baeza & Laura A. Taylor, *A Closer Look at Defensive ESOPs*, 680 P.L.I. CORP. 727, 729-30 (1990); Mario L. Baeza, *Recent Developments in the Use of ESOPs in Mergers and Acquisitions and Finance*, 751 P.L.I. CORP. 121, 129 (1991). *See generally* Timothea Marie Barnatan, *ESOPs as a Defensive Weapon when a Hostile Takeover Rears its Ugly Head*, 38 WAYNE L. REV. 1877 (1992); Hanks, *supra* note 21, at 3.

32. *See* Triantis & Daniels, *supra* note 30, at 1075-76.

agement empire building and the resulting managerial slack.[33] Additionally, all the benefits of an increased debt structure also accrue. However, by using ESOPs as an anti-takeover device, these beneficial results of LBOs are averted and management further entrenches itself.

For a leveraged ESOP, if it is given that (1) the cost of capital is the lowest possible, and (2) managerial slack will not correct itself because of shareholder dilution, the reduced monitoring effects of the debt, and its potential use as an anti-takeover defense, then the questions remain: what are the benefits of the ESOP? Do they outweigh the costs? This query logically leads to an expansive list of questions: Are the employee shareholders taking on even more risk than before? Are the employee-shareholders accorded as many rights as the normal investor? Are employee-shareholders motivated to become more productive? Are the new employee-owners truly empowered to affect corporate governance?

III. ESOPs: Increasing Employer Risk in the Public Corporation

A confusing aspect of the ESOP is its inclusion within the framework of ERISA. By placing the ESOP within ERISA, it is essentially represented as a retirement vehicle. Thus, the ESOP doubles as a device to defer tax on earnings and capital gains just as other retirement vehicles. Whereas some policy reasons for the existence of the ESOP may include economic democracy, redistribution of wealth, improved productivity, and capital formation,[34] it is difficult to see where retirement vehicles fit into these primary objectives, since it does not seem that the main objective of an ESOP is to provide a pension.

Although ERISA is a protective statute meant to safeguard employee pensions from unnecessary risk, most of the protective measures within ERISA provide special exemptions for the ESOP. The concept of risk for an employee-owner is an important one. Shareholders argue that their power in the corpora-

33. *See id.* at 1074-76.

34. *See* Michael W. Melton, *Demythologizing ESOPs*, 45 TAX. L. REV. 363, 366-68, 384 (1991).

tion derives from their willingness to take risks. These risk-takers provide the necessary financial capital which generates employment opportunities. Employees also contribute to the corporation in the form of human capital. This investment combined with at-will employment is a form of risk-taking itself. From a policy perspective, an ESOP should reduce risk because it theoretically allows for greater employee participation. However, this raises two fundamental issues. First, do ESOPs allow for greater employee participation? Second, what does the employee give up in exchange for the ESOP, and is it worth what she gains in return?

A. *ESOP as an Employee Investment*

There are many factors which diminish the value of the ESOP to the employee of a public corporation. Despite the benefits to management in the form of tax incentives for capital formation which the leveraged ESOP represents, it is naive to think that management would confer a benefit upon employees without expecting something in return.[35] Of course, increased productivity may be one employer expectation. Others might include a smaller income, smaller raises, a smaller straight pension fund, and fewer other benefits. In exchange for these concessions, the employee essentially takes on more risk. Several elements of the ESOP create greater risk for the employee: the lack of choice in adopting the plan, the lack of SEC disclosure, the lack of diversification, the lack of transferability, the lack of mirrored voting, the discounted present value of deferred compensation, and weak fiduciary obligations.[36] The confluence of these factors reduce the value of the ESOP to the employee because the overall risk created is so high.

35. *See* Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257 (Del. Ch. 1989) (reasoning that Polaroid proved that its ESOP was related to employee compensation by showing that employees gave up pay and benefits in exchange).
36. *See* Melton, *supra* note 34, at 382-84.

B. *Choice of Investments is a Privilege not Accorded to Employees Under ESOPs*

To fully understand the excess risk accorded to the employee-shareholder in the public corporation, we must compare the normal shareholders to the employee-shareholders under a leveraged ESOP. To begin, normal shareholders may choose what security they purchase. In a leveraged ESOP, management or the board of directors initiates the decision to create an ESOP with little or no employee input.[37] Although the plan must presumably be in the best interests of the employees,[38] the employee-shareholder has little or no input in her choice of investment. The corporation may be motivated by cheap capital formation or antitakeover objectives which supersede the more noble goal of economic democracy. Indeed, it is ironic that the employee is not consulted in the creation of an ESOP that is supposedly in her best interest and for the furtherance of economic democracy. Logic tells us that the first step in democracy is not the exclusion of the beneficiaries in choosing the future plan.

C. *Weak Disclosure Law Unfairly Prejudices Leveraged ESOPs*

Whereas economic democracy suggests that employees need more information, the leveraged ESOP offers less. A public offering requires registration and full disclosure under the Securities Act of 1933, yet a leveraged ESOP offering has no such requirement.[39] The lack of disclosure is relevant in that the employee-shareholder is once again afforded less information than the normal investor.

Generally, purchasers of securities are protected by the Securities Act of 1933[40] and the Securities Exchange Act of 1934.[41]

---

37. *See id.* at 375-76.
38. *See* I.R.C. § 401(a) (1997).
39. *See* Ludwig, *supra* note 20, at 102; Melton, *supra* note 34, at 419 (stating that non-contributory ESOPs have no registration requirements under the Securities Act of 1933).
40. 15 U.S.C. §§ 77(a)-(aa) (1994 & Supp. I 1995).
41. 15 U.S.C. §§ 78(a)-(ll) (1994 & Supp. I 1995).

These protections include mandatory disclosure of financial information[42] necessary to make an informed investment decision, as well as remedies for any false or misleading statements made in connection with the purchase or sale of any security.[43] "The people most likely to benefit from disclosure requirements . . . are those investors for whom the cost of obtaining [necessary] information . . . is prohibitively high."[44] Securities disclosure laws are protective of the unsophisticated investor. "Among participants of ESOPs are an ever-increasing number of blue collar union employees who are relatively unsophisticated . . . . Their need for the Securities Acts' protection is therefore compelling."[45]

In *SEC v. W.J. Howey Co.*,[46] the Supreme Court held that an investment contract is a scheme which involves an investment of money in a common enterprise generating profits solely from the efforts of others. In analyzing the *Howey* test, the Court, in *International Brotherhood of Teamsters v. Daniel*,[47] held that a compulsory, non-contributory pension plan did not constitute an investment contract, and was, thus, not subject to registration under the Securities Act.[48] The lack of a disclosure requirement for leveraged ESOPs distinguishes ESOPs in which the employees make direct cash contributions ("contributory" or "elective" ESOPs) from those in which the ESOP shares are allocated to the employees for "free" (leveraged ESOPs are one of a class of "non-contributory" ESOPs).

The distinction between voluntary and involuntary contributions is confusing.[49] *Childers v. Northwest Airlines*[50] held that

42. *See* 15 U.S.C. § 77(j) (1994).

43. *See* 15 U.S.C. § 77(k) (1994 & Supp. I 1995).

44. Sean S. Hogle, Note, *The Employee as Investor: The Case for Universal Application of the Federal Securities Laws to Employee Stock Ownership Plans*, 34 WM. & MARY L. REV. 189, 190-91 (1992); *see also* Edward E. Bintz, *Fiduciary Responsibility Under ERISA: Is There Ever a Fiduciary Duty to Disclose?*, 54 U. PITT. L. REV. 979 (1993); Mark A. Guetlich, Tenth Circuit Survey, *Securities Regulation Survey*, 69 DENV. U. L. REV. 1019 (1992).

45. Hogle, *supra* note 44, at 191.

46. 328 U.S. 293 (1946).

47. 439 U.S. 551 (1979).

48. *See id.* at 551-52.

49. *See* Mario L. Baeza & Laura A. Taylor, *The Applicability of Federal Securities Laws to Employee Bargained for ESOPs*, 680 P.L.I. CORP. 703, 708 (1990).

50. 688 F. Supp. 1357 (D. Minn. 1988).

the Northwest ESOP was not subject to the antifraud provisions of the Securities Exchange Act of 1934 because the wage concessions collectively given in exchange for the employee stock represented a method of deferring income, not a method of reducing wages to pay for stock.[51] In *Uselton v. Commercial Lovelace Motor Freight*,[52] the Tenth Circuit held that the employees' *individualized* agreements to reduce wages in exchange for an interest in a leveraged ESOP satisfied the *Howey-Daniel* test.[53] Presumably, the collective vote ruined the Northwest employees chance of passing the *Howey-Daniel* test.[54]

In the case of an ESOP, these judicial distinctions are unjust. Indeed, the Delaware Chancery Court listed the implicit employee exchange requirement in the Polaroid ESOP as one of several elements necessary to render leveraged ESOPs legally valid antitakeover devices.[55] Thus, wage concessions are required to use an ESOP as an anti-takeover device.[56] Further, the unilateral imposition of both the leveraged ESOP and resulting wage concessions together will not require the employer to either register the securities or be held accountable under federal antifraud statutes.[57] The law allows the employee to go unconsulted regarding ESOP formation and adoption, and actually encourages the employer to exclude employee input as to the wage concessions. Including the employee in the discussion would result in the employer assuming the expense of securities registration and allowing the employee-shareholders to avail themselves of federal antifraud statutes.

Perhaps most importantly, ESOPs deal with stock, not the more obscure "investment contract." "[T]he public perception of common stock as the paradigm of a security suggests that stock, in whatever context it is sold, should be treated as within the ambit of the Acts."[58] In *SEC v. Ralston Purina Co.*,[59]

51. *See id.* at 1362-64.
52. 940 F.2d 564 (10th Cir. 1991).
53. *See id.* at 576-77.
54. *See* Hogle, *supra* note 44, at 217.
55. *See* Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 274-75 (Del. Ch. 1989).
56. *See id.*
57. *See* Baeza & Taylor, *supra* note 49, at 713.
58. Reves v. Ernst & Young, 494 U.S. 56, 62 (1990) (quoting Landreth Timber

the Supreme Court dealt with the issue of whether a company's offer of stock to its employees was exempt from registration under the Securities Act of 1933.[60] The Court upheld the SEC injunction against further sales of the stock because

> the focus of inquiry should be . . . on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with [registration].[61]

Investor protection should be a paramount goal for an ESOP precisely because corporations frequently do not establish ESOPs for the best interests of the employee.[62] When ESOPs are used to entrench current management and to defend against potential takeover, "the potential for abusive and fraudulent behavior is clear."[63]

D. *Lack of Diversification Further Increases Employee Risk*

The normal investor has an additional advantage in that she can diversify her investments. A more diversified portfolio reduces market risk and achieves risk reduction without reducing the overall rate of return. Whereas the normal investor has the capital to diversify, the employee-owner does not. For many employees, the same vehicle holding their retirement also holds their only investments. Difficulty in achieving diversity is compounded by the fact that ESOPs invest almost entirely in one company.[64]

Ironically, ERISA exists to protect employee pensions from this very type of undiversified risk taking. However, ESOPs are exempted from this provision and allowed to invest only in the

---

Co. v. Landreth, 471 U.S. 681, 687, 693 (1985)).

59. 346 U.S. 119 (1953).

60. *See id.* at 120.

61. *Id.* at 127.

62. *See* Hogle, *supra* note 44, at 227.

63. *Id.*

64. *See* Adam Bryant, *Betting the Farm on the Company Stock*, N.Y. TIMES, Apr. 16, 1995, § 3, at 1.

originating company. From the perspective of an individual employee's personal portfolio, an ESOP represents no diversification.[65] In fact, employee-ownership makes an employee's portfolio even less diversified as she has compounded her lack of diversification by investing both human capital and financial capital, whether through direct contributions or sacrificing pay and benefits, in the same corporation. From the perspective of the entire ESOP/pension portfolio, there is a lack of diversification on a much larger scale. Further, the employee risks accumulate even more due to the lack of a real exit option.

E. *Lack of Transferability Exacerbates Employee Risk*

The employee's inability to choose to adopt the leveraged plan and the resulting decreased diversification of the employee's investments significantly increase the risk to the employee. However, the problem may worsen. ESOPs have very strict rules on transferability. As a program of deferred compensation under ERISA, the employee has no ability to sell her shares of the company until employment terminates or the employee retires.[66]

The inability of the employee to sell her shares tremendously increases risk. If the company is doing poorly, the employee is incapable of protecting herself, even with adequate information. Additionally, the inability of the employee to at least partially sell her shares eliminates her voice in corporate governance.[67] Contrary to economic democracy, restrictions on transferability effectively negate the monitoring effects that the exit option has in controlling management and signalling the market. In contrast, normal shareholders have this ability to influence and participate in corporate governance.

It is ironic that employee-shareholders, those in the position to most directly monitor the inner workings and inefficiencies of

---

65. ESOPs do have "to provide some diversification of investment for employees who are nearing retirement." Melton, *supra* note 34, at 397. This represents one of the few instances where the retirement security policies of ERISA win out over employee stock ownership. *See id.*

66. *See id.* at 383.

67. *See id.*

the corporation, are completely restricted from exercising this option. Removing the exit option from any group of shareholders deepens the entrenchment of management.

Frequently, in the leveraged ESOP, only a small portion of the total employee stock block is allocated to individual employees. This is because the stock is held in escrow and allocated gradually as the ESOP loan is paid down. Thus, even if the employee could sell her shares, they may represent a very small amount. Even if transferability restrictions did not exist, management effectively restricts the entire block of ESOP stock from playing an "exit" role in corporate governance.

Another issue arises when the value of an employer's stock takes a significant tumble. Does the employee, through the trustee, have an ability to sell or diversify when the company approaches dire straits? Is anyone held responsible for looking after the employees best interests?

F. *Fiduciary Duties and ESOP Trustees: No One is Responsible to the Employee-Shareholder*

The contradictory nature of placing the ESOP within the regulatory framework of ERISA curtails the responsibilities of the ESOP trustee. One of the principal components of the regulatory scheme established by ERISA is its fiduciary duty.[68] ERISA fails to protect leveraged and other ESOPs even though ERISA imposes fiduciary standards on persons who have discretionary authority with respect to the management of plan assets or administration of a plan.[69] The catch is that the leveraged, non-contributory ESOP, by its very single investment nature, gives its trustees limited, if any, discretion with respect to the management of the plan assets.[70]

Whereas ERISA's fiduciary duties mandate diversification and a prudently managed employee portfolio (including selling when the market price of a security is tumbling severely), ERISA exempts ESOPs from these provisions. Further, ESOPs

68. *See* Bintz, *supra* note 44, at 980-83.

69. *See* Moench v. Robertson, 62 F.3d 553, 561 (3rd Cir. 1995).

70. *See* Michael S. Melbinger, *Significant Rulings: ESOP Trustee Decisions*, PENSION WORLD, Dec. 1995, at 46.

are exempted from ERISA's strict prohibitions against dealing with a party in interest and against self-dealing.[71] Several cases serve to illustrate both the disproportionate financial risk of owning company stock through an ESOP and the weakness of ERISA fiduciary duties in protecting ESOP plan participants.

In *Moench v. Robertson*,[72] a former employee sued Statewide Bancorp's ESOP for breach of fiduciary duty.[73] The suit was based on the ESOP committee's decision (the ESOP committee was the plan trustee) to invest solely in employer common stock during a two-year period when the stock fell from $18.25 per share to less than $0.25 per share.[74] The controlling language of the plan stated, "within 30 [sic] days of receipt, the Trustee shall invest all contributions . . . in ESOP stock, except that the Trustee shall be authorized to invest a portion of the contributions received in other securities as a reserve for the payment of administrative expenses and cash distributions."[75] Most ESOPs require full investment in the employer stock, that being the overriding purpose of an ESOP. If the ESOP trustee has no discretion in investing plan assets, she is absolved of fiduciary duty. Therefore, as a general matter, by complying with the ESOP provisions, a trustee complies with ERISA's fiduciary standards.[76]

In *Moench*, the plan left the "discretionary" door open by allowing at least some small investment in non-ESOP securities. Here the Third Circuit applied an abuse of discretion standard to the trustee to determine whether she had violated her fiduciary duties to the ESOP participants by not diversifying.[77] The court reasoned that "an ESOP fiduciary who invests the assets in employer stock is entitled to a presumption that it acted consistently with ERISA by virtue of that decision. However, the plaintiff may overcome that presumption by establish-

71. *See Moench*, 62 F.3d at 568.
72. 62 F.3d 553 (3rd Cir. 1995).
73. *See id.* at 559.
74. *See id.* at 557.
75. *Id.* at 558.
76. *See id.* at 571.
77. *See id.* at 571; *see also* RESTATEMENT (SECOND) OF TRUSTS § 187 (1989).

ing that the fiduciary abused its discretion by investing in employer securities."[78]

With ESOP trustees accorded little, if any, discretion, the abuse of discretion standard serves little purpose. Even with some discretion allowed, as in *Moench*, the Third Circuit warned that "[i]n determining whether the plaintiff has overcome the presumption, the courts must recognize that if the fiduciary, in what it regards as an exercise of caution, does not maintain the investment in the employer's securities, it may face liability for that caution, particularly if the employer's securities thrive."[79] As a result, the Third Circuit further insulated the already over protected ESOP trustee from fiduciary liability. Meanwhile, employees with no ability to sell their investment in Bancorp must watch idly while the management-appointed ESOP trustee continues to invest and then refuses to divest of employer stock while it falls precipitously, heading straight for bankruptcy.

In *Kuper v. Iovenko*,[80] the Sixth Circuit came to conclusions similar to those of the Third Circuit in *Moench*, but added a twist by throwing the business judgement rule into the mix.[81] In *Kuper*, former salaried employees of Quantum sued their former employer when, after selling the company to Henkel, the salaried employees' ESOP was not distributed for eighteen months.[82] During the delay, Quantum stock dropped from over $50 to approximately $10 per share.[83]

"Quantum entered into an Asset Sale Agreement to sell its Emery Division to Henkel."[84] The two companies also entered

78. *Moench*, 62 F.3d at 571.
79. *Id.* at 571-72.
80. 66 F.3d 1447 (6th Cir. 1995).
81. *See id.* at 1459.
82. *See id.* at 1450-52; *cf.* Wulf v. Quantum Chemical Corp., 26 F.3d 1368 (6th Cir. 1994), *cert. denied*, 513 U.S. 1058 (1994). In *Wulf*, the court awarded hourly workers of the same company judgement because the Trustee abused her discretion. The *Kuper* court distinguished the cases based upon the existence of the following factors: (1) after the sale, Henkel refused to effect a trust-to-trust transfer for the hourly workers' ESOP; (2) Quantum amended the plan to unequivocally provide for distribution in the event that Quantum sold all of its assets (regardless of continued employment); and (3) the employees believed they had been terminated when they left Quantum and went to work for Henkel. *See Kuper*, 66 F.3d at 1451, 1455-56.
83. *See Kuper*, 66 F.3d at 1451.
84. *Id.* at 1450.

into an Employment Agreement, where Henkel agreed to continue employing existing Emery employees. The Employment Agreement also stated that Henkel would accept a trust-to-trust transfer of the ESOP assets for those Quantum employees who continued employment with Henkel after the sale. The transfer of plan assets was not completed until eighteen months after the stock price had fallen by eighty percent.[85] The court held that Quantum did not breach its fiduciary duty to ESOP plan participants for its failure "to make discretionary distributions to . . . plan participants between [the] sale of [the] division and [the] trust-to-trust transfer," and the fiduciary duty "to investigate liquidating or diversifying ESOP assets during trust-to-trust transfer did not rise to [the] level of breach."[86]

In *Kuper*, the ESOP allowed the fiduciaries some discretion. The *Kuper* ESOP "required immediate distribution of an employee's ESOP funds upon the employee's termination," but it "also granted its fiduciaries discretion to distribute . . . ESOP . . . [funds] upon the sale by Quantum of substantially all of its assets or . . . one of its subsidiaries, provided that the employee continued employment with the buyer."[87]

The plain words of the ESOP agreement indicated that the Quantum ESOP fiduciaries had discretion to liquidate or distribute before the trust-to-trust transfer occurred.[88] However, the Sixth Circuit invoked the business judgement rule in concluding that the fiduciaries had no discretion at all:

> [G]iven that the decision to make the trust-to-trust transfer was a corporate . . . decision, . . . [the fiduciaries] had no power or duty to override that decision . . . [P]urely business decisions by an ERISA employer are not governed by . . . [ERISA's] fiduciary standards . . . . There is no dispute that Quantum's decision to arrange a trust-to-trust transfer was not a fiduciary one . . . . We, therefore, conclude that defendants cannot be held to have breached their

85. *See id.* at 1450-51.
86. *Id.* at 1447.
87. *Id.* at 1450.
88. *See id.* at 1457 (discussing conclusion that Quantum's fiduciaries did have discretion).

> fiduciary duty to plaintiffs by virtue of their failure to override a corporate business decision.[89]

The employees also argued that there was a breach of fiduciary duty for failing to at least diversify during the eighteen month lag period.[90] Here, the Sixth Circuit adopted the Third Circuit's abuse of discretion standard and appeared to take the Third Circuit's advice in making it a difficult obstacle to overcome. Despite the fact that the stock's price fell by eighty percent in eighteen months, the court reasoned that a reasonable fiduciary would have continued to hold Quantum's stock during the period at issue.[91] The court based this reasoning on the fact that "Quantum stock [had] closed at or above the previous day's trading price on 181 of the 402 trading days during . . . [this] period,"[92] and that several investment advisors had rated the security as a "hold."[93] Indeed, the employees must have thought they had a strong argument for abuse of discretion since there was no evidence that the fiduciaries ever considered selling the Quantum stock during the price decline period.[94] Nevertheless, the Sixth Circuit reasoned that an investigation by the fiduciaries of the alternatives was unnecessary unless the employees could prove "that an adequate investigation would have revealed to a reasonable fiduciary that the investment at issue was improvident."[95]

Moench and *Kuper* reveal the inadequacy of fiduciary protection facing the employee-shareholder in an ESOP. "While the failure to divest ESOP stock before the employer goes bankrupt may still be a recipe for an ERISA lawsuit, *Moench* and *Kuper* leave us more optimistic about the eventual outcome for the fiduciaries."[96]

---

89. *Id.* at 1456-57 (internal citations omitted).
90. *See id.* at 1457.
91. *See id.* at 1459.
92. *Id.* at 1451.
93. *See id.* at 1460.
94. *See id.* at 1459-60.
95. *Id.* at 1460.
96. *3rd and 6th Circuits Apply Abuse of Discretion Standard to Failure of ESOP Fiduciaries to Diversify Plan Assets*, 4 No. 5 ERISA LITIG. REP. 16, 20 (1995).

G. *The Last Straw: Voting Rights as a Token Offering Where the Reality Further Entrenches Management*

Yet another corporate governance tool for shareholders is the ability to vote for the board of directors and other proxy matters. Once again, however, for the employee-shareholder in a leveraged ESOP, this governance tool is frequently rendered irrelevant. Some argue that management entrenchment occurs in an ESOP because employees are perceived as friendly to management and are thus more inclined to vote in management's favor. Although this argument is not foolproof, the judicial extermination of "mirrored" voting in an ESOP has made the waters even murkier.[97]

Because large blocks of employee stock in a leveraged ESOP are unallocated, most ESOPs have traditionally allowed for "mirrored" voting. Mirrored voting means that the ESOP trustee must vote the unallocated shares of the ESOP in the same proportion that the employees vote the allocated shares. The Internal Revenue Code § 409(e)(5) allows ESOPs to authorize the trustee to vote all plan shares in proportion to the voting instructions received from plan participants.[98] However, the district court in *Reich v. NationsBank* ruled that the voting rights requirement of ESOPs applies only to allocated shares.[99] The court reasoned that "the conflict problem arises from the fact that 'present participants have no interest in voting for what will benefit participants in the future if such a vote results in those benefits going to persons other than themselves.'"[100] Perhaps even more disconcerting, the *NationsBank* court gives the trustee full discretion in voting allocated shares in instances where she has received no directions.[101]

The court in *NationsBank* reasoned that in a leveraged ESOP there is a division of ownership: the allocated shares (usually

97. *See* Reich v. NationsBank, CIV. A. No. 1:92-CV-1474-HTW, 1995 WL 316550 (N.D. Ga. Mar. 29, 1995).

98. *See* 26 U.S.C. § 409(e)(5)(1994).

99. *See NationsBank*, 1995 WL 316550, at *5.

100. *Id.* at *6 (quoting Danaher Corp. v. Pneumatic Tool Co., 635 F. Supp. 246, 250 (S.D.N.Y. 1986)).

101. *See id.*

the vast minority in the instance of a recently formed ESOP) are owned by the current participants/employees, and the unallocated shares are owned by the future participants/employees.[102] If employee voting simply follows management direction, perhaps this distinction is irrelevant. However, if employee voting is a genuine corporate governance tool enabling the employee-shareholder to exercise her voice, the ability to do so through a leveraged ESOP has been eviscerated. She can vote her allocated shares, but it is left to the ESOP trustee to vote the disproportionately large unallocated shares prudently, in the interests of both present and future participants.

This consequence implies that an "independent" trustee may recognize conflicts of interest between present and future plan participants and thus direct the unallocated share votes accordingly. Ironically, the plan trustee inevitably has limited fiduciary responsibility to the ESOP participants and is also often a member of management. Such a system not only diminishes the impact of voting by current employee-shareholders but it also creates a greater lack of accountability for the not-so-independent trustee who can formulate reasons for voting large blocks of unallocated shares based upon the best interests of future participants. The fiduciary duties of the ESOP trustees are confusing and the voting rights of employees extremely limited, compounding the disadvantage to the employee so benevolently granted economic democracy.

IV. ESOP EFFECT ON EMPLOYEE MOTIVATION AND PRODUCTIVITY

Having arrived at the topic of the leveraged ESOPs effect upon employee motivation and productivity, it seems relevant to revisit the original impetus for this essay. Does employee ownership through a leveraged ESOP create any form of economic democracy? Is it a legitimate answer to opportunistic management behavior to place employee job security at risk?

---

102. *See id.* at *5.

At first glance, the concept seems ideal. The director's fiduciary duty would extend to the employee as a shareholder herself. Thus, in evaluating a potential layoff in the context of shareholder wealth maximization, the layoff would be less likely to occur because a shareholder's wealth is likely not maximized by losing her job. Combined with increased job security, the employee-shareholder would benefit from wealth redistribution while playing a more participatory role in corporate governance. The employee would be charged with the knowledge that she can keep at least a portion of the residual value created by her human capital. Ideally we are left with a more motivated, self-monitoring work force sharing information with and monitoring management, while shirking its job responsibilities less. The net result of a more secure, wealthier employee with a piece of the action would result in higher corporate productivity.

However, to examine the effect of a leveraged ESOP on employee motivation and productivity seems irrelevant in light of the tremendous disadvantages to employees which it creates. The aforementioned disadvantages notwithstanding, even if one assumes that employee-shareholders hold the same property rights as other shareholders, there are many problems with the hypothesis that ESOPs improve employee motivation and productivity.

The first problem is to determine how employees are motivated. Theories of motivation can be divided into two categories: (1) content approaches and (2) process approaches.[103] Content approaches focus on identifying specific motivation factors.[104] Process approaches focus on describing how behavior is motivated.

103. *See, e.g.*, JOHN M. IVANCEVICH & MICHAEL T. MATTESON, ORGANIZATIONAL BEHAVIOR AND MANAGEMENT 159-60 (4th ed. 1996).

104. Some content theories of motivation include: Maslow's Need Hierarchy, Alderfer's ERG Theory, Herzberger's Two Factor Theory, and McClelland's Learned Needs Theory. *See id.* at 159-66. *See generally* CLAYTON P. ALDERFER & LAYTON P. ALDERFER, EXISTENCE, RELATEDNESS AND GROWTH: HUMAN NEEDS IN ORGANIZATIONAL SETTINGS (1972); FREDERICK HERZBERG, B. MAUSNER & B. SNYDERMAN, THE MOTIVATION TO WORK (1959); HERBERT PETRI, MOTIVATION: THEORY AND RESEARCH 4 (1979); David C. McClelland, *Business Drive and National Achievement*, HARVARD BUS. REV., July-Aug. 1962, at 99; Lyman W. Porter, *A Study of Perceived Need Satisfaction in Bottom and Middle Management Jobs*, J. APPLIED PSYCHOL., Feb. 1961, at 1.

Content approaches focus on the specific needs that motivate people. Content approaches to motivation focus upon a hierarchical need system in which the basic needs such as salary, job security, satisfactory work conditions, and reasonable interpersonal relationships form the bottom of the motivational pyramid.[105] Self-actualization, esteem, growth, and the need for achievement and power form the top of the motivational pyramid. Under the content approach, money and job security are lower level needs, motivating only minimally. However, participation, responsibility, advancement, and growth are higher level needs and thus greater motivators.[106] Thus, under a content approach, employee ownership must be structured towards satisfying higher level needs to provide increased motivation.

Under content theories of motivation, stock ownership without participation will not appeal to higher level needs and thus, will not serve to motivate.

The very nature of a leveraged ESOP removes the content that could encourage greater employee motivation. For the employee in the public corporation, the leveraged ESOP permits no employee choice in the adoption of the plan, no disclosure or availment of antifraud statutes, limited fiduciary obligations, limited voting rights (especially in the early stages) without mirrored voting, and no exit option. In effect, it is ownership without property rights. This type of pseudo-ownership will not appeal to higher level needs and thus motivational potential is limited.

The process theories of motivation, instead of focusing on specific motivation factors within a person causing behavior, focus on the external factors causing behavior. Process theories focus on reward structures.[107] An expectancy process theory would evaluate motivation based upon the employee's perception of the probability of her personally attaining a desired level of performance, coupled with the potential rewards and the value the employee places on those rewards. In an equity process theory, the employee compares her efforts and rewards with those of others in similar work situations. These theories

105. *See* A.H. Maslow, *A Theory of Human Motivation*, 50 PSYCH. REV. 370 (1993).

106. *See* IVANCEVICH & MATTESON, *supra* note 103, at 165-66.

107. *See id.* at 167.

are based on the assumption that employees are motivated by different rewards and also maintain motivation through equitable treatment.[108]

Under process theories of motivation, rewards only motivate when the employee values the reward and perceives equity in the reward structure. Why would an employee value the reward of ownership without property rights? The ownership carries a large risk factor, including the lack of disclosure and diversification, stock price risk and the discounted value of deferred compensation. The lack of property rights combined with other risk factors creates a high discount factor, reducing the present value to any rational individual.

An ESOP does not create the perception of equity in rewards necessary under a process theory of motivation. A leveraged ESOP's compensation is based upon salary structures, equally rewarding employees at the same pay scale regardless of individual effort and results. Such a system does not create equity. In fact, it runs the risk of creating free rider problems because of the weak connection between individual effort and reward.

Even outside of perceived equity, employees in a large public corporation may feel their efforts are too diluted to affect the stock price. The actions and reactions of Wall Street and resulting fluctuations in stock prices can seem random even to the experts. The result is too tenuous a connection between individual effort and the resulting stock price.

There are many problems with past ESOP studies, perhaps the least of which is that they have yielded divergent results.[109] The most recent study on employee ownership and productivity attempts to analyze all past studies as a whole. "The relationship of employee-ownership to employee perfor-

---

108. *See id.* at 168.

109. *See* Joseph Blasi et al., *Employee Stock Ownership and Corporate Performance Among Public Companies*, 50 INDUS. & LAB. REL. REV. 60 (1996); *see also* Avner Ben-Ner & Derek C. Jones, *Employee Participation, Ownership and Productivity: A Theoretical Framework*, 34 INDUS. REL. 532 (1995); Derek C. Jones & Takao Kato, *The Productivity Effects of Employee Stock-Ownership Plans and Bonuses: Evidence from Japanese Panel Data*, 85 AM. ECON. REV. 391 (1995) (suggesting positive productivity effects of ESOPs). *But see* James S. Hirsch, *Avis Employees Find Stock Ownership Is Mixed Blessing*, WALL ST. J., May 2, 1995, at B1 (identifying limitations of ESOPs); Darryl Jenkins, *Another Airline in a Stock Swamp*, N.Y. TIMES, Apr. 2, 1995, at 15.

mance has been the subject of at least 27 previous studies, covering a variety of forms of employee ownership and measures of performance. Few of these studies have individually found strong and statistically significant effects of employee ownership on performance."[110] A study of the economic performance effects of ESOPs, specifically in publicly traded companies, concluded that no automatic relationship between ESOPs and improved firm performance exists.[111] A problem in the analysis is how to measure productivity. Should productivity be measured by profits, output per worker, or share price appreciation? Another problem is one of attribution. Is the increase in productivity due to newly motivated workers, improvement in capital intensity, management, or technical aspects of production?[112]

ESOP studies on productivity are contradictory, flawed or incomplete. Organizational behavior theories provide little guidance in predicting employee motivation. Some employees may prefer group based incentives to deter co-worker shirking, while others may prefer incentives based upon individual performance.[113] Designing reward systems is difficult because individuals are too different. Generalizing one reward over a large group is ineffective. The distribution of equity across a workforce will not have the same effect on every worker. Increased productivity may be perceived as a benefit of ESOPs; however, the reality is that employee motivation is too complex for a generalized result.

In the face of a lack of empirical evidence, and accepting social science reasoning that employee motivation is too complex for a generalized result, where is the improved productivity to be found? The answer must be improved labor-management relations.

Improved labor-management relations is also a complex objective. It is a product of trust,[114] participation and cooperation

110. Blasi et al., *supra* note 109, at 66.

111. *See* Joseph R. Blasi, *The Productivity Ramifications of Union Buyouts*, 9 NAT'L PRODUCTIVITY REV. 17 (1989-1990).

112. *See* Blasi, *supra* note 109, at 65; *see also* ROBERT J. KUHNE, CO-DETERMINATION IN BUSINESS 15 (1980); MARSHALL *supra* note 10, at 186; COREY M. ROSEN ET AL., EMPLOYEE OWNERSHIP IN AMERICA 50 (1986).

113. *See* Blasi et al., *supra* note 109, at 65.

114. *See generally* Lawrence E. Mitchell, *Trust. Contract. Process.*, *in* PROGRESSIVE

that can only be accomplished with the proper corporate culture directed by a willing management. Employee ownership as an incentive by itself cannot accomplish this objective. Ironically, the leveraged ESOP provides little motivational reward for employees and little motivation for management to improve labor relations and create a more participatory workplace.

V. CONCLUSION

The underlying contradiction of the leveraged ESOP is that it must exist for the exclusive benefit of the employees. Yet its very structure, emphasizing its value as a corporate finance tool, contradicts the exclusive benefit rule. Ironically, management gains far too much from a tax subsidy theoretically constructed for the exclusive benefit of the employee.

The leveraged ESOP is a phenomenal corporate finance tool that entrenches management instead of encouraging economic democracy through employee participation. The leveraged ESOP has more than all the financial benefits of debt, including the fact that it is an inexpensive source of capital due to below market interest rates, deductible contributions and dividends, and no disclosure and placement costs. However, it carries none of the benefits of reducing managerial slack and entrenchment because the monitoring effects of strict covenants and informational trip wires, more concentrated ownership and danger of insolvency are nearly nonexistent. Additionally, the beneficial effects of equity in reducing managerial slack are defeated because no signaling mechanism exists due to the lack of an exit option and insignificant voting rights for the employee-held shares. Employees gain deferred compensation in exchange for explicit and implicit wage concessions, but are left with no choice in adoption, no disclosure, no diversification, no transferability, weak and conflicted fiduciary representation, and no mirrored voting. In essence, management dictates terms to employees who have no say, allowing management to grow stronger on the backs of employees who are bearing greater risk. This is not a prescription for economic democracy. If anything, it is quite the opposite.

CORPORATE LAW 185, *supra* note 2, at 185.

However, a significant objective in the legislative formation of ESOPs appears to be improved management relations.[115] Yet the structure of leveraged ESOPs fails to legally require (either by statute or by judicial precedent) employee participation. If some laborers have long suffered in the American capitalist system and its particular form of corporate governance, those who sought to treat this affliction are guilty of a degree of paternalism so extreme as to defeat a fundamental purpose for which it was intended.

The paternalism evidenced in the leveraged ESOP is a product of legislative and judicial failure. Paternalism manifests itself in the leveraged ESOP through the underlying theme that management knows what is best for the employees. First, it is paternalistic to decree by statute that an ESOP must be created in "the exclusive interests of [the] employees"[116] while, at the same time, allowing management to unilaterally impose the plan. Second, it is paternalistic for the judiciary to rule that securities disclosure is not required for a unilaterally imposed ESOP, or even for one adopted by a collective employee vote (because the ESOP is deemed free or non-contributory). Once again, this encourages management to decide what is best for its employees because allowing employees to individually choose a leveraged ESOP would actually increase the cost to the corporation, resulting in management incentives to exclude employee participation at initiation. Third, it is paternalistic for a statute to allow and for the judiciary to rule that an ESOP trustee (usually a part of management or allied with management) who complies with the management created ESOP plan automatical-

115. *See* BLASI, *supra* note 13, at 190-92. Indeed, ESOPs coupled with real employee participation programs have consistently been found to improve productivity. *See* Dan Bannister, *Making Employee Ownership a Competitive Advantage,* MGMT. REV., Aug. 1995, at 46; Chris Doucouliagos, *Worker Participation and Productivity in Labor-Managed and Participatory Capitalist Firms: A Meta-analysis*, 49 INDUS. & LAB. REL. REV. 58 (1995); Edward J. Giblin et al., *When Employees Own the Company,* ACROSS THE BOARD, Oct. 1995, at 42; Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749 (1990); Anne Murphy, *Taking the Fall, Inc.*, Sept. 1995, at 81; Portia Richardson, *Making Workers Act Like Owners*, INSTITUTIONAL INVESTOR, Nov. 1995, at 31; *Republic and McLouth: Two ESOPs on Different Paths*, NEW STEEL, Nov. 1995, at 16; *Employee Participation and Labor-Management Cooperation in American Workplaces*, CHALLENGE, Sept.-Oct. 1995, at 38.

116. I.R.C. § 401(a) (1997).

ly complies with ERISA's fiduciary duties. Finally, it is paternalistic for the judiciary to rule against mirrored voting of unallocated ESOP shares because of the conflict between present and future employee beneficiaries, and to instead allow the management appointed ESOP trustee to use his best judgement.

Proponents of ESOPs believe that ownership will "unite labor and management in a common endeavor without changing the structure of power or prestige between them."[117] It is naive and ironic to suggest that labor-management relations could improve without changing the structure of power and participation. Nevertheless, even the famous ESOP pioneer, Louis Kelso, defended this world view when he said:

> A basic tenet of two-factor economics is that the function of ownership and the function of management are two entirely distinct functions. It is postulated that any human being can be an owner of productive capital and that, ideally, every individual would actually own a viable holding of such shares. However, it is not a postulate of two-factor economics that every individual is qualified to manage a corporation. The ideal corporation is one in which promotion from level to level in the corporate hierarchy is possible and easy. Nevertheless, "management is a rare and difficult art; the health and success of the corporation as a whole depends upon its having the highest quality of management."[118]

This view, from the employee champion himself, assumes that adding employee ownership, by itself, without any employee participation or involvement programs, will improve labor-management relations. With the leveraged ESOP, there is no legal requirement to encourage labor-management participation. Granting ownership without property rights is a smokescreen for perpetuating the status quo. Absolute management rights do not create a common interest between labor and management and a joint partnership in the firm.[119]

---

117. BLASI, *supra* note 13, at 234.

118. *Id.* (citing *Employee Stock Ownership Plans: Hearings Before the Joint Economic Committee*, 94th Cong. 202 (1975) (statement of Louis Kelso)).

119. *See id.* at 136.

"At the core of Kelso's argument is the proposition that the debt-financed acquisition of capital assets through an ESOP will create wealth without any new savings or investment by employees."[120] Herein lies the fundamental philosophical flaw and source of paternalism relative to leveraged ESOPs. Economic democracy, that is to say, a fundamental shift in corporate governance, seems no more than a secondary goal. Kelso conceived of the ESOP as a method for employees to gain something for nothing and that, beyond wealth redistribution, labor-management relations and, hence, productivity would magically come to pass.

However, the concept that the employee receives something for nothing undermines any possibility of improved relations and productivity. Employees receive just about nothing, ownership without property rights, in exchange for something, explicit and implicit concessions. Management gains greater power and is encouraged to act opportunistically. Employees receive nothing because the argument was framed in terms of them giving up nothing. The courts have agreed that securities in a leveraged ESOP not approved individually by every employee are indeed free (non-contributory) and thus subject to less rights. In addition, Congress encourages and rewards the behavior with tax subsidies.

Ironically, even Kelso's concept of wealth redistribution under a leveraged ESOP is both a functional and motivational failure. As a tool for wealth redistribution, the ESOP faces the fundamental failure that its benefits are distributed proportionally to employee salaries. Those making the most money earn the greatest ownership share. Indeed, this would seem to create greater disparities in wealth, even if those employees who never owned stock would certainly own more under an ESOP than before. As a motivational and productivity tool, the lack of participation and ownership rights cannot fulfill the employees' higher level needs (content theory of motivation), and incentives based upon salary structure as opposed to performance encourage free riders because they are not equitable (process theory of motivation).

120. Melton, *supra* note 34, at 368.

I do not suggest that Congress' and Louis Kelso's roles in the conceptual and statutory creation of the leveraged ESOP were mal-intended, but rather severely misguided. I do not mean to suggest that all leveraged ESOPs function to the detriment of employees, used by opportunistic management to entrench themselves, with little or negative productivity benefits. I merely suggest that the default rules facilitate such a result. At a minimum, the leveraged ESOP must require management to submit a plan of employee participation as well as continued implementation which meets appropriate guidelines. At a maximum, employees must be given: a choice in adoption, full disclosure, the ability to diversify investments and/or sell shares, an independent trustee with strong fiduciary obligations, and mirrored voting.

Corporate finance is the only true purpose for a leveraged ESOP that is not coupled with the proper corporate culture and significant employee participation. The structure of the leveraged ESOP as a corporate finance tool actually widens the gap between management and labor. Nevertheless, the problems are correctable. However, until such corrections occur, the leveraged ESOP as a response to the call for economic democracy is a cruel joke at best.

Hunter C. Blum